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INDUSTRIAL PRIME VENDOR PROGRAM AT THE
NAVAL AVIATION DEPOT - CHERRY POINT

Report No. D-2001-171

August 6, 2001

Office of the Inspector General
Department of Defense

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Abstract

This report is one in a series involving the pricing of commercial and noncommercial spare parts and other logistics support initiatives. This report addresses bench-stock material (screws, bolts, rivets, etc.) and logistics support procured from Raytheon E-Systems Incorporated under the industrial prime vendor program to support the Naval Aviation Depot, Cherry Point, North Carolina. Report No. D-2001-072, "Industrial Prime Vendor Program at the Naval Aviation Depot North Island," March 5, 2001, addressed the program at the Naval Aviation Depot, North Island, California. A third audit will address the industrial prime vendor program at the Air Force Logistics Centers. The Defense Supply Center Philadelphia initiated the industrial prime vendor program in July 1998 as a test or demonstration program to explore innovative logistics solutions for providing spare parts used in maintenance, repair and overhaul facilities. The conceptual goal of the industrial prime vendor program was to improve logistics support to the service depot maintenance facilities at a lower cost by streamlining the logistics pipeline. The industrial prime vendor program is a customer oriented supply chain management initiative that turns complete responsibility of bench- stock material over to a third-party vendor. The primary customers covered under the demonstration program are Navy depots and Air Force logistics centers. FY 2001 budget figures show overall bench-stock sales at about \$284 million, which includes the industrial prime vendor bench-stock sales at about \$38 million. The Defense Supply Center Philadelphia awarded industrial prime vendor contract (SP0500-98-D-BP03) to Raytheon on August 19, 1998 to support Cherry Point. The contract has an estimated material value of \$15 million annually. Also, the contract provides approximately \$1,260,000 in annual overhead costs and \$450,000 in annual transportation costs. From contract inception (August 1998) through July 2000, program sales totaled \$1,569,120 (\$720,605 spot buys; \$655,368 preexpended bin; and \$193,147 Navy industrial fund). Raytheon is responsible for purchasing bench stock and maintaining the stock bins. Raytheon used direct vendor delivery contracts with a core team of subcontractors to supply the material.

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Acronyms

CRR	Cost Recovery Rate
DLA	Defense Logistics Agency
DODAAC	Department of Defense Activity Address Code
DSCP	Defense Supply Center Philadelphia
EA	Each
HD	Hundred
IPV	Industrial Prime Vendor
MAUC	Mean Acquisition Unit Cost
NIF	Navy Industrial Fund
NSN	National Stock Number
PEB	Pre-Expended Bin
SUP	Standard Unit Price



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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August 6, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on the Industrial Prime Vendor Program at the Naval Aviation Depot – Cherry Point (Report No. D-2001-171)

We are providing this audit report for your information and use. This report is one in a series involving pricing and logistics support for commercial and noncommercial spare parts. We considered management comments on a draft of this report when preparing the final report.

The Defense Logistics Agency comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288) or Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink, appearing to read "Thomas F. Gimble".

Thomas F. Gimble
Acting
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-171

(Project No. D1999CF-0104.001)

August 6, 2001

Industrial Prime Vendor Program at the Naval Aviation Depot – Cherry Point

Executive Summary

Introduction. This report is one in a series involving the pricing of commercial and noncommercial spare parts and other logistics support initiatives. This report addresses bench-stock material (screws, bolts, rivets, etc.) and logistics support procured from Raytheon E-Systems Incorporated under the industrial prime vendor program to support the Naval Aviation Depot, Cherry Point, North Carolina. Report No. D-2001-072, “Industrial Prime Vendor Program at the Naval Aviation Depot–North Island,” March 5, 2001, addressed the program at the Naval Aviation Depot, North Island, California. A third audit will address the industrial prime vendor program at the Air Force Logistics Centers. The Defense Supply Center Philadelphia initiated the industrial prime vendor program in July 1998 as a test or demonstration program to explore innovative logistics solutions for providing spare parts used in maintenance, repair and overhaul facilities. The conceptual goal of the industrial prime vendor program was to improve logistics support to the service depot maintenance facilities at a lower cost by streamlining the logistics pipeline. The industrial prime vendor program is a customer oriented supply chain management initiative that turns complete responsibility of bench-stock material over to a third-party vendor. The primary customers covered under the demonstration program are Navy depots and Air Force logistics centers. FY 2001 budget figures show overall bench-stock sales at about \$284 million, which includes the industrial prime vendor bench-stock sales at about \$38 million.

The Defense Supply Center Philadelphia awarded industrial prime vendor contract (SP0500-98-D-BP03) to Raytheon on August 19, 1998 to support Cherry Point. The contract has an estimated material value of \$15 million annually. Also, the contract provides approximately \$1,260,000 in annual overhead costs and \$450,000 in annual transportation costs. From contract inception (August 1998) through July 2000, program sales totaled \$1,569,120 (\$720,605 spot buys; \$655,368 preexpended bin; and \$193,147 Navy industrial fund). Raytheon is responsible for purchasing bench stock and maintaining the stock bins. Raytheon used direct vendor delivery contracts with a core team of subcontractors to supply the material.

Objective. The primary audit objective was to determine whether the Defense Supply Center Philadelphia industrial prime vendor program had demonstrated an effective shift to commercial, industrial-base resources as an integrated logistics solution to obtain bench-stock material and add value for its customers.

Results. The Defense Supply Center Philadelphia industrial prime vendor program at Cherry Point had not placed sufficient bench-stock material on contract to demonstrate an effective shift to commercial, industrial-base resources as an integrated logistics solution to support Cherry Point. As a result, Raytheon was primarily relying on the Defense supply system for the bench-stock material used to support the program at Cherry Point. In fact, 82 percent (dollars) and 84 percent (line items) of material supplied by Raytheon came from the Defense supply system. In short, Raytheon was effectively managing bench-stock material, but was unable to obtain more than 16 percent of the material from sources other than the Defense Logistics Agency. Although the industrial prime vendor program provided additional resources to manage bench-stock material at Cherry Point and improve parts availability, the program will not become cost effective unless Raytheon can place sufficient material on contract at economical prices (finding A).

Raytheon also erroneously charged Cherry Point for material on the contract. We calculated that Cherry Point was overcharged by \$666,883 because of problems with unpriced items, units of issue, and contract oversight. Raytheon refunded \$337,893 to Cherry Point on June 1, 2000. Similar conditions were reported at North Island in Report No. D-2001-072. For details of the audit results, see the Finding section of this report (finding B).

Summary of Recommendations. We recommend that the Commander, Defense Supply Center Philadelphia direct industrial prime vendor contract prices be renegotiated within established cost goals and provide alternatives to keep conventional bench-stock support competitive by either reducing costs or increasing sales. The supply center should also calculate a fair and consistent cost recovery rate for traditional bench-stock material to effectively evaluate the cost effectiveness of the industrial prime vendor program. We also recommend that the supply center obtain a full refund for erroneous charges and fully reimburse Cherry Point and implement procedures to detect and prevent erroneous billings on future invoices.

Management Comments. The Defense Supply Center agreed to review actual parts usage with updated demand to identify cost drivers for repricing. The supply center agreed to look at alternatives for bench-stock support and is developing “generation II” of the industrial prime vendor program. The supply center agreed to use the appropriate cost recovery rates to place items on contract and for program evaluation purposes. The supply center agreed to provide an exit strategy for Cherry Point with the industrial prime vendor generation II. The supply center agreed to refund Cherry Point an appropriate amount of overcharges and to implement procedures to prevent erroneous billings on future invoices.

Although no comments were required, the Naval Aviation Depot Cherry Point, North Carolina commented on the report findings and recommendations. The depot stated that better material availability is provided under this contract.

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Background

Spare Parts Audits. This report is one in a series involving the pricing of commercial and noncommercial spare parts. This report addresses bench-stock material and logistics support procured from Raytheon E-Systems Incorporated under the industrial prime vendor (IPV) program. Table 1 shows the items included in bench-stock material and the Federal Supply Class (FSC).

Table 1. Bench Stock Material and Federal Supply Class	
<u>Material</u>	<u>FSC</u>
Gaskets and packing	5330, 5331
Nuts and washers	5310
Screws, bolts, and studs	5305, 5306, 5307
Nails, pins, and rivets	5315, 5320, 5325

Demonstration Program. The Defense Supply Center Philadelphia (DSCP) initiated the IPV program in July 1998 as a test program to explore innovative logistics solutions for providing maintenance, repair, and overhaul facilities with spare parts. The conceptual goal of the IPV program was to improve logistics support to service depot maintenance facilities at lower costs by streamlining the logistics pipeline. A justification for other than full and open competition was approved and a limited number of site-specific contracts were awarded so that the concept could be evaluated. The program was designed for a 5-year test period. During the 2-year contract base period, material management responsibility was expected to migrate from the Government to the contractor's full responsibility within 3 years. As performance progressed on initial contracts, metrics would be established to assess the impact of total logistics costs and readiness posture at specific sites.

The Defense Logistics Agency (DLA) is maintaining its logistics support system concurrent with the new system as a backup logistics system. Once the new logistics systems have been fully tested and determined successful, performance metrics will be refined and the program will be converted to a fully competitive acquisition environment targeting consolidated requirements based on common missions and/or weapon system. At that time, the concurrent systems would become redundant and require functional adjustments. DSCP awarded a number of IPV contracts to various contractors to support Defense depots throughout the world. This report only addresses the Raytheon IPV contract at the Naval Aviation Depot – Cherry Point, (Cherry Point), North Carolina. Additional audit reports will assess the IPV program at other sites.

DSCP awarded Raytheon the Cherry Point IPV contract (SP0500-98-D-BP03) on August 19, 1998. The contract was valued at about \$15 million annually, with approximately \$1,260,000 in annual distribution (infrastructure) costs and

\$450,000 in annual transportation costs. Raytheon purchased bench stock to maintain stock bins at or near where depot maintenance was performed. Raytheon did not stock inventory but used direct vendor delivery contracts with various companies to supply items directly to Cherry Point. In the event that Raytheon could not economically purchase an item, contract clauses authorized Raytheon to supply the material from DLA stock. Raytheon did not earn profit on materials obtained from DLA stock. The IPV program was designed to provide benefits for DoD and direct benefits to the warfighters. Table 2 shows the intended IPV program benefits.

Table 2. Intended IPV Program Benefits	
<u>Reduced</u>	<u>Increased</u>
Logistics response time	Readiness
Customer material costs	Financial accountability
Transactions	Rapid response
Inventory investment	Material availability
Storage, handling, and transportation costs	Opportunities for infrastructure streamlining

Section 912 Report. Section 912(c) of the FY 1998 National Defense Authorization Act directed the Secretary of Defense to submit an implementation plan to Congress that streamlined acquisition organizations, workforce, and infrastructure. In response, the Secretary of Defense submitted a report to Congress, "Actions to Accelerate the Movement to the New Workforce Vision," April 1, 1998. The report included a section that addressed prime vendor contracts.

Greatly Expanded Prime Vendor and Virtual Prime Vendor. As a result of the revolutions in the marketplace - in terms of transportation, manufacturing, and technology - it is no longer necessary for DoD to manage supplies. What DoD needs to do is manage suppliers through programs such as Prime Vendor; and where Prime Vendor is not a commercial practice in a particular sector, create a Virtual Prime Vendor which accomplishes the same outcome through the use of technology. This initiative will reduce the number of personnel and the amount of infrastructure we need to support our warfighters. It will also improve delivery of products and services, but will require the acquisition of new skills by our existing workforce.

Objective

The primary audit objective was to determine whether the Defense Supply Center Philadelphia industrial prime vendor program had demonstrated an effective shift to commercial, industrial-base resources as an integrated logistics solution to obtain bench-stock material and add value for its customers. See Appendix A for a discussion of the audit scope and methodology, and Appendix B for prior coverage related to the audit objectives.

A. Bench-Stock Material

DSCP had not placed sufficient bench-stock material on the IPV contract with Raytheon to demonstrate an effective shift to commercial, industrial-base resources as an integrated logistics solution to support the Naval Aviation Depot – Cherry Point. This condition occurred because the IPV contractor was unable to obtain material as economically as DSCP and meet established cost goals to place material on contract. In addition, about a third of the material placed on contract was clearly not within established cost goals (79.3 percent higher than DLA cost). As a result, Raytheon was primarily using the DLA supply system to obtain bench-stock material to support the IPV program at Cherry Point. Overall, 82 percent (dollars) and 84 percent (line items) of the material supplied by Raytheon came from the DLA supply system. Although the IPV program provided additional resources to manage bench-stock material at Cherry Point and improved parts availability, the program will not become cost effective unless sufficient material can be placed on contract at economical prices. Also, transitioning bench-stock sales from conventional support to the IPV program without corresponding infrastructure cost reductions is causing the DSCP cost recovery rate for conventional bench-stock material support to increase, effectively “lowering the bar” for measuring the cost effectiveness of the IPV program.

IPV Program Concept

Streamlining the Logistics Pipeline. DSCP designed the IPV program to streamline the logistics pipeline by transferring procurement and logistics support requirements for bench-stock material from DSCP to Raytheon. Raytheon was responsible for ordering, purchasing, receiving, stocking, and billing bench-stock material. Raytheon’s purchasing departments and on-site employees at Cherry Point accomplished these contract requirements. The IPV concept called for Raytheon to serve as an integrator and establish contracts with manufacturers that would ship the bench-stock parts directly to Cherry Point (direct vendor delivery). DSCP believed that Raytheon could supply parts more efficiently and effectively by taking advantage of the commercial supply chain as compared to the DLA supply system. DSCP touted the IPV program as a model for DoD procurement and logistics support.

Figure 1 shows the DSCP purchasing model for the IPV program.

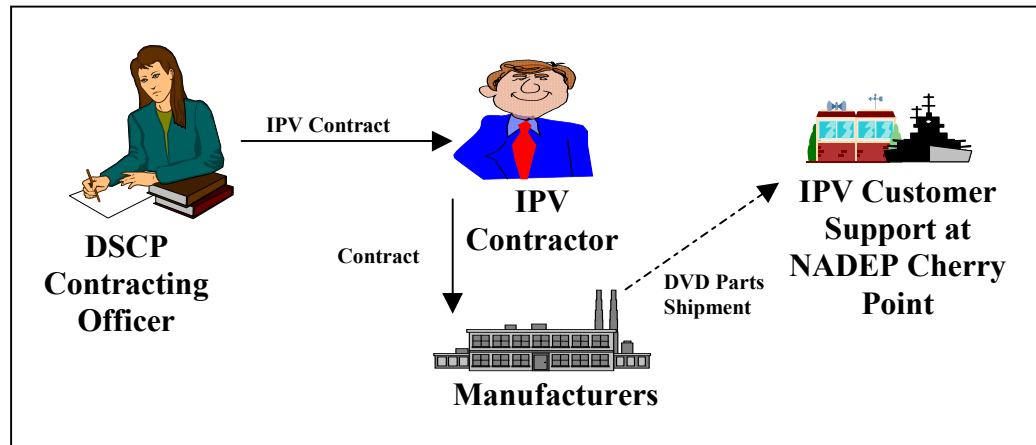


Figure 1. DSCP Model for the IPV program

Placing Material on IPV Contract at Economical Prices. The basic concept for placing material on the IPV contract at economical prices was that Raytheon's unit prices for bench-stock parts supplied through the commercial supply chain needed to be within 80 percent of the DLA standard unit price (SUP). The SUP is the price DLA charged its customers. The SUP was derived from the mean acquisition unit cost (MAUC), the actual price DLA paid for items and included the cost recovery rate charged by the supply center responsible for managing the item. The cost recovery rate recouped supply center operations costs, depot costs, corporate and other miscellaneous costs. For example, if DSCP purchased an item for \$100 (the MAUC) and its cost recovery rate was 40 percent, the DLA customer price for the item was \$140 (the SUP).

Reasonable Cost Goal. Raytheon basically needed to obtain the item for no more than 80 percent of the SUP for an item to be included on the IPV contract within a reasonable cost goal. Raytheon added a 6 percent profit on all material provided through its commercial supply chain and also charged a fixed amount for annual infrastructure costs (\$1,260,000) and for annual transportation costs (\$450,000). Raytheon can also receive a 2 percent award fee. DSCP then added a 5.7 percent special cost recovery rate for the IPV program. In theory, if sufficient items had been included on the IPV contract, Raytheon's profit, infrastructure, and transportation costs, and the DSCP surcharge would have been offset by the 20 percent difference in material from the DLA SUP. If items were included on contract at prices higher than 80 percent of the SUP, the IPV program would cost more than if the items were provided from the DLA supply system.

Figure 2 (DSCP figures) shows the initial cost comparison used by DSCP to promote the IPV program savings at Cherry Point. The calculations show the cost of traditional DLA support versus anticipated IPV program support costs. Again, DSCP calculated that Raytheon could purchase material at 80 percent of the DLA SUP (\$15 million DLA material amount versus \$12 million Raytheon material amount). The DLA material costs include the applicable cost recovery rate.


 <h2 style="text-align: center;">Cherry Point</h2> <h3 style="text-align: center;">Total Yearly Cost Comparison</h3>			
	<u>DLA</u>		<u>Raytheon</u>
Material	\$15,000,000	Material	\$12,000,000
		Transportation	\$450,000
Infrastructure (15 Personnel)	\$750,000	Infrastructure	\$1,289,400
		8 % Profit/ Award Fee	\$960,000
Fee	<u>\$0</u>	DSCP Surcharge	<u>837,866</u>
	\$15,750,000		\$15,537,266
		Savings	(\$212,736)
Supporting America's Fighting Forces			

Figure 2. DSCP's Initial IPV Program Calculations Show Minimal Savings

We were unable to substantiate the \$750,000 (15 personnel) infrastructure costs at Cherry Point used in Figure 2.

Material on Contract

DSCP had not placed sufficient bench-stock material on the IPV contract with Raytheon to demonstrate an effective shift to commercial, industrial-base resources as an integrated logistics solution to support the Naval Aviation Depot – Cherry Point. This condition occurred because the IPV contractor was unable to obtain material as economically as DSCP and meet established cost goals to place material on contract. In addition, about a third of the material placed on contract was clearly not within established cost goals (79.3 percent higher than DLA cost). As a result, Raytheon was primarily using the DLA supply system to obtain bench-stock material to support the IPV program at Cherry Point, in fact 82 percent (dollars) and 84 percent (line items) of the material supplied by Raytheon came from the DLA supply system.

Market Baskets. DSCP used “market baskets” or groups of items to add material to the IPV contract. The market basket approach meant that some items could be higher than 80 percent of the SUP while others were lower; but cumulatively, the total costs should not exceed 80 percent of the SUP. Raytheon submitted groups of items (with expected demand quantities) to DSCP for approval. DSCP added items to the contract without regard to individual unit prices if the market baskets

met the 80 percent criteria. Raytheon used the DLA supply system for those items that were not procurable within the 80 percent SUP threshold or caused the market basket to exceed 80 percent without earning a profit.

Contract Prices for Items Billed. IPV contract prices for items actually billed exceeded the 80 percent threshold (items prices not at least 20 percent below SUP) because about a third of the items placed on contract (\$239,577) were clearly not within the established cost goal. For cost comparison purposes we used both the DLA MAUC and the SUP. The MAUC provided a more consistent measure because of the significant increases in the DSCP cost recovery rates (CRR) for bench-stock material. For example, if DSCP paid \$100 for an item, the SUP for that item would have been \$140 (40 percent CRR) in FY 1999, \$157.20 (57.2 percent CRR) in FY 2000, and \$174.90 (74.9 percent CRR) in FY 2001. Therefore, the 80 percent SUP threshold would have varied from \$112 (.8 x \$140) in FY 1999, to \$125.76 in FY 2000, to \$139.92 in FY 2001.

Table 3 shows that overall, IPV contract prices for bench stock material were 40.4 percent higher than the MAUC and only 8.7 percent below the SUP. The contract prices for items not within established costs goals were 17.2 percent higher than the SUP.

Table 3. Comparison of IPV Bench-Stock Contract Prices With the DLA MAUC and SUP

<u>Contract/ Modification</u>	<u>Lines Billed</u>	<u>Contract Price</u>	<u>FY 2000 DLA Price</u>		<u>CRR (percent)</u>	<u>Percent Difference</u>	
			<u>MAUC</u>	<u>SUP</u>		<u>MAUC</u>	<u>SUP</u>
<u>Within established cost goals</u>							
P00010	1,792	\$238,630	\$195,702	\$296,704		21.9	(19.6)
P00011	150	75,560	66,329	103,993		13.9	(27.3)
P00021a	309	53,059	43,156	69,445		22.9	(23.6)
P00048	29	2,604	1,579	2,957		64.9	(11.9)
P00050	5	1,110	812	1,258		36.7	(11.8)
P00053	24	525	585	719		(10.2)	(26.9)
Subtotal	2,309	\$371,488	\$308,163	\$475,076	54.2	20.5	(21.8)
<u>Not within establish cost goals</u>							
Basic	531	\$146,020	\$75,464	\$117,087		93.5	24.7
P00004	385	103,461	71,453	109,111		44.8	(5.2)
P00031	1,035	31,272	9,632	13,371		224.7	133.9
P00047	1	14	5	8		167.4	75.9
Subtotal	1,952	\$280,767	\$156,554	\$239,577	53.0	79.3	17.2
Total	4,261	\$652,255	\$464,717	\$714,653	53.8	40.4	(8.7)

DSCP needs to renegotiate IPV contract prices on contract modifications not within established cost goals (about 20 percent above MAUC or below SUP). Recommendation 1.a., in Report No. D-2001-072 addressed the need to perform periodic reviews to determine whether parts usage established during contract

pricing, agrees with actual usage, when using market baskets. Recommendation 1.d., addressed the need to establish metrics that compare the MAUC with IPV contract costs, and to not place items on contract if costs exceed 120 percent of the MAUC. Therefore, similar recommendations in this report were not made.

Material on the IPV Contract. Even though bench-stock material was placed on contract at prices that exceeded the established cost goals, sufficient material had not been placed on contract to make the program cost effective and the majority of the material was being supplied from the DLA supply system.

Figures 3 (transactions) and Figure 4 (dollars) show that for Invoices 2 (first invoice) through 19 (July 2000), IPV commercial sales (items the contractor was able to procure and supply) were significantly less than the value of the items being supplied by the DLA supply system.

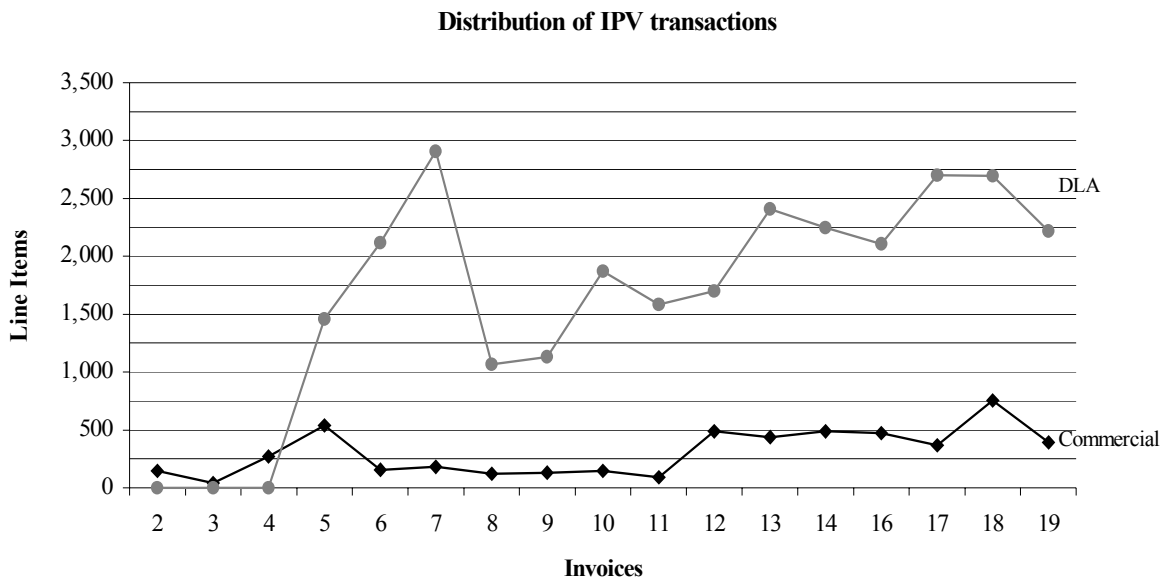


Figure 3. Most IPV transactions (line items) are from the DLA Supply System

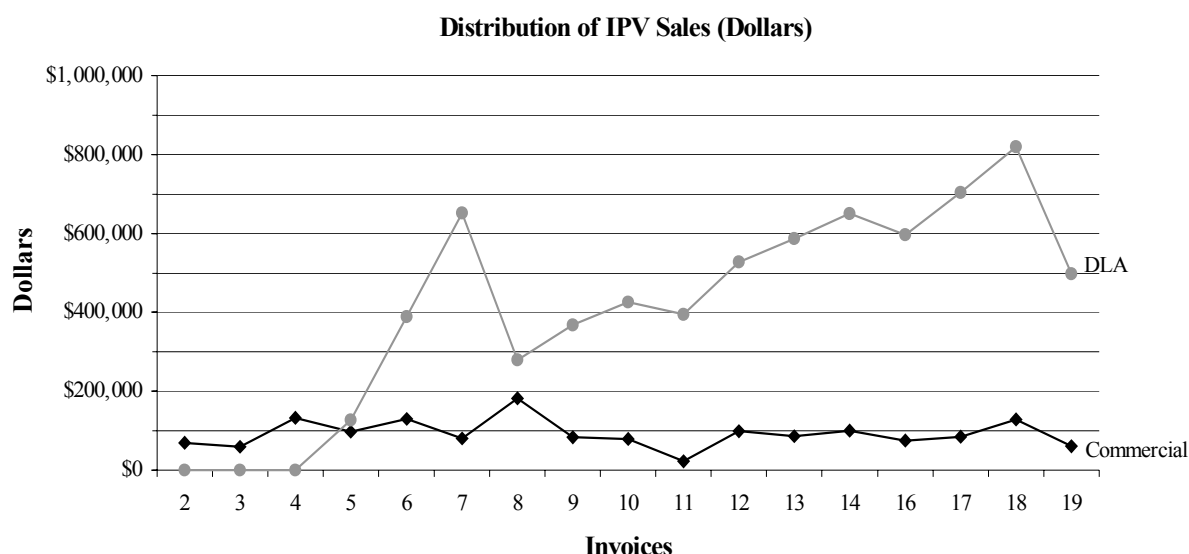


Figure 4. Most IPV Sales (dollars) are from the DLA Supply System

Total commercial sales transactions were 15.6 percent (5,226) of the total IPV transactions, while 84.4 percent (28,197) of the transactions represented DLA sales. Total commercial sales were 18.3 percent (\$1,569,120) of the total dollars while DLA sales (items obtained from the DLA supply system) were 81.7 percent (\$7,017,169).

Recommendation 1.f., in Report No. D-2001-072 addressed the need to establish program metrics for bench-stock material that show a significant shift in the number of transactions supplied from its depot system to industry, establish time frames to attain the metrics, and if unable to achieve the established metrics, discontinue the program. Therefore, a similar recommendation in this report was not made.

Bench-Stock Business

Bench Stock Business. Although the IPV program provided additional resources to manage bench-stock material at Cherry Point and improved parts availability, the program will not become cost effective unless sufficient material can be placed on contract at economical prices. Also, transitioning bench-stock sales from conventional support to the IPV program without corresponding infrastructure cost reductions is causing the DSCP cost recovery rate for conventional bench-stock material support to increase, effectively lowering the bar for measuring the cost effectiveness of the IPV program.

Availability of Parts. Even though data were not available on parts availability prior to the IPV program, it would be difficult to dispute the claim that the IPV program at Cherry Point had increased parts availability; however, significantly more resources were devoted to managing bench-stock material under the IPV program. Prior to the IPV contract, Cherry Point felt it was short-staffed by 20 personnel in managing bench-stock material. The staffing shortages were primarily for material handlers and parts attendants. Cherry Point had requested

but was denied funding for 20 additional staff from the Navy Comptroller. The IPV program alleviated this staff shortage by providing 23 additional contractor personnel to manage bench-stock material but the infrastructure costs associated with these additional resources were about \$1.26 million. Under the IPV program, these additional personnel costs are included in the IPV program costs. Along with providing additional resources, the IPV contract also provided a significant change in the management of bench-stock items from the Navy industrial fund stores to pre-expended bins.

Accordingly, while parts availability at Cherry Point had increased, availability of parts supplied from the DLA depot system and by the IPV contractor was the same even though four times as many bench-stock bins were supplied with material from the DLA depot system. As of December 15, 2000, Raytheon provided material for 4,248 item bins (19.1 percent) and material for 18,039 item bins (80.9 percent) was supplied by DLA. We reviewed empty bin reports provided by Raytheon from July through December 2000. However, the reports do not differentiate between the number of Raytheon managed bins and DLA managed bins. To determine the number of bins managed by Raytheon and DLA, we used the ratio established from total parts supported. The average number of bench stock bins managed was 18,331. On average, 94 bins were empty. Raytheon was responsible for 16 empty bins and 78 empty bins were DLA's responsibility. Therefore, the parts availability compliance rate was 99.5 percent for both Raytheon (3,494) and DLA (14,837 bins).

Increases in Bench-Stock Conventional Cost Recovery Rates. During FY 1999, the DSCP cost recovery rate for bench-stock material ranged from 38.0 percent for gaskets and packing to 42.3 percent for nuts and washers and averaged about 40 percent. When decisions were made to place items on the IPV contract, DSCP compared the proposed prices from the IPV contractor to the DLA FY 1999 SUP or sell price, which included the cost for material and the applicable cost recovery rate. However, in FY 2000, DSCP established a separate cost recovery rate for bench-stock items. The new DSCP rate was significantly higher, 57.2 percent, than the DSCP overall cost recovery rate of 39.8 percent. The FY 2001 cost recovery rate for bench stock was even higher, 74.9 percent, while the overall DSCP cost recovery rate was only 40.5 percent. These higher rates enabled Raytheon to purchase items at higher prices and include them on the contract. We reviewed the various cost elements of the bench-stock cost recovery rates for FYs 2000 and 2001 and determined that the rates did not accurately reflect the costs associated with DSCP managing bench-stock material. In addition, the true IPV surcharge was understated.

Tables 4 and 5 show that if costs not directly associated with bench-stock material were removed, and if the IPV program was discontinued, the cost recovery rates for bench-stock material would be 45.3 for FY 2000 and 49.4 percent for FY 2001. Table 5 also shows IPV program sales at \$38 million about 13.4 percent with traditional sales at \$245.83 million.

Table 4. DSCP FY 2000 Cost Recovery Rates (millions)					
<u>Cost Elements</u>	<u>Overall</u>	<u>Bench Stock</u>	<u>IPV</u>	<u>Adjusted* Bench Stock</u>	<u>Bench Stock And IPV</u>
ICP operations	\$98.04	\$ 30.90	\$ 7.04	\$30.90	\$ 37.94
Depot operations	133.60	65.00	0.00	53.00	53.00
Corporate	27.09	12.53	0.00	12.50	12.50
Material related	44.51	16.32	0.00	16.32	16.32
Other/inflation	5.78	18.79	(5.89)	2.87	2.87
Total costs	\$309.02	\$143.54	\$ 1.15	\$115.59	\$122.63
Sales	\$776.60	\$250.90	\$20.00	\$250.90	\$270.90
Cost Recovery Rates	39.8%	57.2%	5.7%	46.1%	45.3%
*Includes Depot operations and other non-bench stock related adjustments.					

Table 5. DSCP FY 2001 Cost Recovery Rates (millions)					
<u>Cost Elements</u>	<u>Overall</u>	<u>Bench Stock</u>	<u>IPV</u>	<u>Adjusted* Bench Stock</u>	<u>Bench Stock and IPV</u>
ICP operations	\$112.63	\$ 38.94	\$4.82	\$ 38.94	\$ 43.76
Depot operations	110.00	57.26	0.00	57.26	57.26
Corporate	107.27	56.68	0.00	22.56	22.56
Material related	30.93	12.10	0.00	12.10	12.10
Other/inflation	12.74	19.18	(2.64)	4.49	4.65
Total costs	\$373.57	\$184.16	\$2.18	\$135.35	\$140.33
Sales	\$923.00	\$245.83	\$38.00	\$245.83	\$283.83
Cost Recovery Rates	40.5%	74.9%	5.7%	55.1%	49.4%
*Includes Defense Reutilization and Marketing Service and other non-bench stock adjustments.					

Recommendation 1.c., in Report No. D-2001-072, addressed the need to use an appropriate cost recovery rate for bench-stock material in the 45 to 50 percent range when decisions are made to place items on contract and for program evaluation purposes. Therefore, a similar recommendation in this report was not made.

Impact of Cost Recovery Rates Increases. As conventional bench-stock sales are transitioned to the IPV program without corresponding infrastructure cost reductions, the DSCP cost recovery rate for traditional bench-stock support increases. Increases in the DSCP cost recovery rates effectively lower the bar for measuring the cost effectiveness of the IPV program. The upward trend in the DSCP cost recovery rate for bench-stock material also raises concerns because funds are shifted from buying material to paying for support. The DSCP bench-stock CRR or cost of sales was 40 percent in FY 1999, 57.2 percent in FY 2000, and in 74.9 percent in FY 2001.

Figure 5, a model using \$10 million as the amount spent by Cherry Point (with \$750,000 for infrastructure costs) shows how increasing cost recovery rates for bench-stock material translates into less material. The model shows that Cherry Point would have received over \$6.6 million of material at the 40 percent CRR in FY 1999 (line A), \$5.9 million of material in FY 2000 (line B), and only \$5.3 million of material in FY 2001 (line C) at the 74.9 CRR.

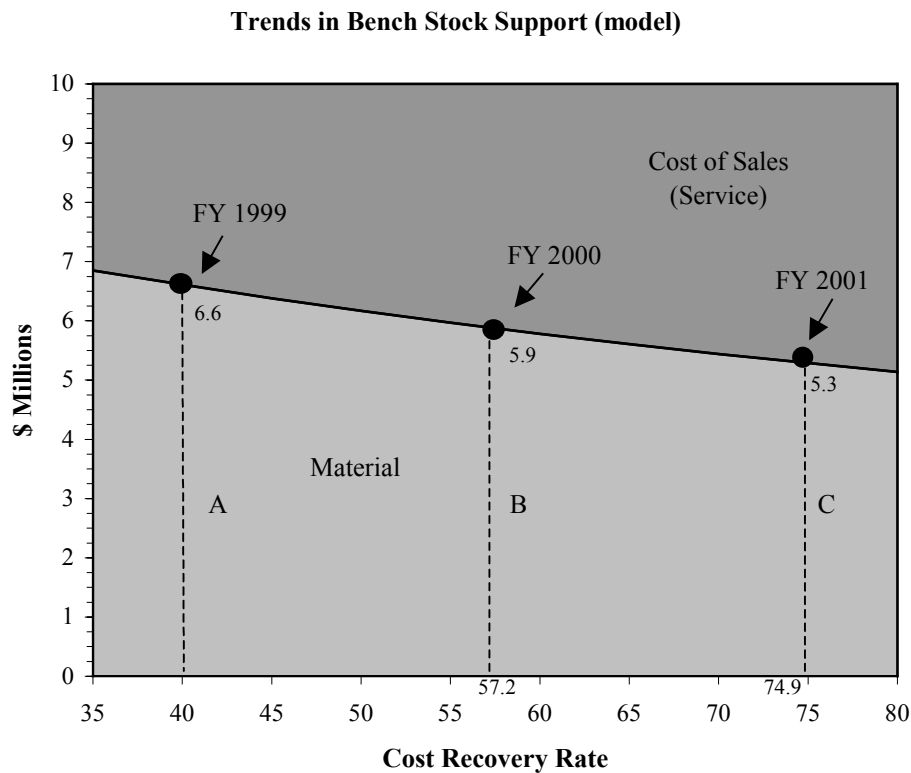


Figure 5. DSCP Bench Stock Customers are Receiving Less material and Paying More for Support.

As in any commercial business, cost of sales as a percentage of sales is a key factor for a business to be successful. Normally, when sales are declining, commercial companies are forced to reduce costs to remain competitive. DSCP needs to focus on conventional bench-stock support and provide alternatives to remain competitive by either reducing costs or increasing bench-stock sales. Ideally, DSCP would strive to accomplish both alternatives.

Measuring the Cost Effectiveness of the IPV Program. The cost-effectiveness of the IPV program is based on a comparison with conventional prices for bench-stock material. Unfortunately, the comparison with conventional support changes dramatically from year to year with changes in the DSCP cost recovery rate. Consequently, as the DSCP cost recovery rate for bench-stock material increases and DSCP becomes less efficient in managing conventional bench-stock material, the IPV program appears more cost-effective.

Figure 6, is a model that shows the price above the DLA MAUC that the IPV contractor would have to obtain sufficient material to break even with DLA conventional support when compared with DLA bench-stock prices shown in Figure 5 for FYs 1999 through 2001. The model uses \$10 million as the amount spent by Cherry Point with \$274,875 for transportation costs, \$1,289,400 for infrastructure costs, a Raytheon fee at 8 percent, and a DSCP cost recovery rate at 5.7 percent.

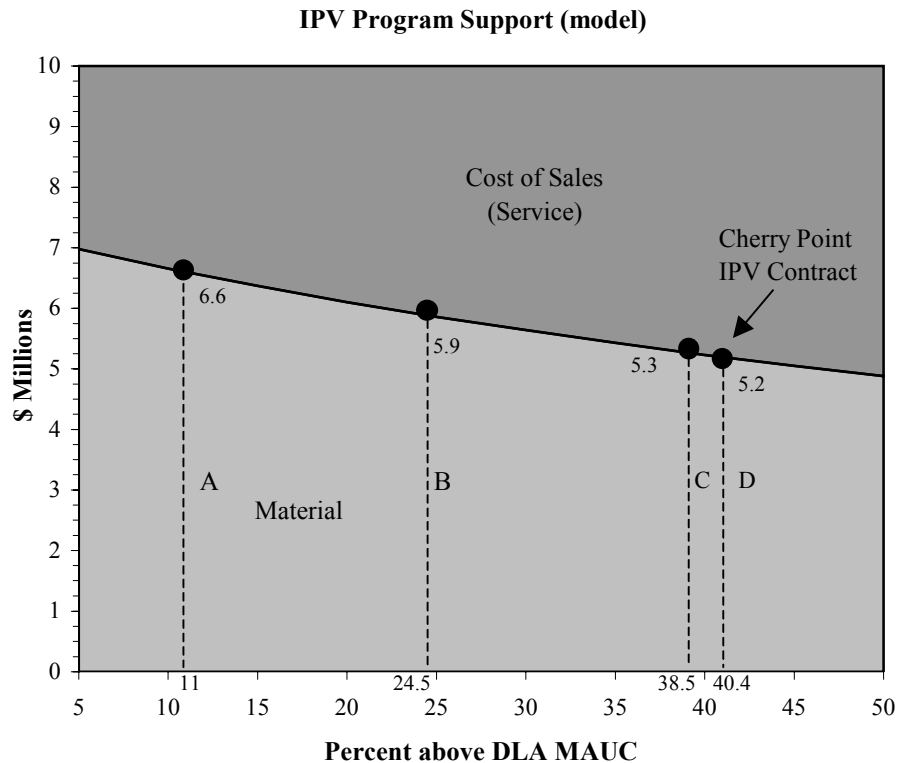


Figure 6. The IPV Program Becomes Less Cost-Effectiveness as the Percent Above the DLA Price Increases

Using 40.4 percent (D), as the difference between the IPV contract price and the DLA price calculated in Table 3 for bench-stock material, the IPV program would cost significantly more than conventional DLA support when compared to FY 1999 (A) or FY 2000 (B) prices. The IPV program would cost only slightly more than conventional DLA support when compared to FY 2001 (C) prices.

DSCP needs to calculate a fair and consistent cost recovery rate for traditional bench-stock material to effectively evaluate the cost effectiveness of the IPV program. The fair and consistent cost recovery rate for traditional bench-stock material should exclude unrelated or IPV program expenses and should also address the impact of transferring sales from traditional support to IPV program support.

Summary

The IPV program at Cherry Point has been highly touted as a best commercial business practice—an improved way for DLA to manage suppliers and not supplies. Unfortunately, the IPV contractor has not demonstrated that it can obtain bench-stock material as cost effectively as DSCP for the current program to become viable. We remain skeptical about the IPV contractor's ability to obtain bench-stock material as effectively as DSCP using only direct vendor delivery contracts with its suppliers. DSCP needs to develop an exit strategy for Cherry Point, in case the IPV contractor continues to be unable to obtain bench-stock material as cost effectively as DSCP. We also remain skeptical about the role and the effectiveness of DLA as a manager of suppliers as opposed to a supply manager.

Whether the IPV program is a commercial business practice that can be used by DLA to effectively provide better, faster, and cheaper support for bench-stock material around the world, around the clock is not close to being demonstrated.

Management Comments on the Finding and Audit Response

Although not required to comment, the Naval Aviation Depot—Cherry Point provided the following comments on the finding.

Management Comments. The Naval Aviation Depot—Cherry Point stated that the initial DSCP IPV cost comparison in figure 2 projected \$450,000 for transportation that was not charged or implemented under this contract. For the full text of the Navy comments, see the Management Comments section of the report.

Audit Response. We agree that the \$450,000 was not charged under the contract. Figure 2 was provided for information purposes as the initial DSCP cost comparison that showed program cost saving. The figure also showed Raytheon provided \$12 million of material annually. Between August 1998 through July 2000, Raytheon only supplied about \$1.6 million of material or 13 percent of the expected amount.

Recommendations and Management Comments

A. We recommend that the Commander, Defense Supply Center Philadelphia:

- 1. Direct that IPV contract prices be renegotiated on contract modifications that are not within established cost goals (about 20 percent above mean acquisition unit cost or below standard unit price).**
- 2. Provide alternatives to keep conventional bench-stock support competitive by either reducing costs or increasing bench-stock sales.**
- 3. Calculate a fair and consistent cost recovery rate for traditional bench-stock material to effectively evaluate the cost effectiveness of the IPV program. The fair and consistent cost recovery rate for traditional bench-stock material should exclude unrelated or IPV program expenses and should also address the impact of transferring sales from traditional support to IPV program support without reducing infrastructure costs.**
- 4. Develop an exit strategy for Cherry Point, in case the industrial prime vendor contractor continues to be unable to obtain bench-stock material as cost effectively as the Defense supply centers.**

Management Comments. The Defense Logistics Agency concurred with the recommendations and agreed to review actual parts usage with updated demand for repricing. Management agreed to look at alternatives for bench-stock support and is developing generation II of the industrial prime vendor program. Management agreed to use the appropriate cost recovery rates to place items on contract and for program evaluation purposes. Management agreed to provide an exit strategy for Cherry Point with the industrial prime vendor generation II.

B. Contract Pricing

Raytheon erroneously charged the Naval Aviation Depot–Cherry Point for bench-stock material on the IPV contract. This condition occurred because unpriced contract items were improperly charged to the contract at prices higher than the DLA standard unit price, because of problems relating to different units of issue, and inadequate oversight of contract billings. As a result, Cherry Point was overcharged \$666,883 (\$328,990 for unpriced items and \$337,893 because of bar-coding system errors) from contract inception (August 1998) through April 2000. Raytheon refunded \$337,893 to Cherry Point on June 1, 2000 to correct the bar-coding system errors.

Unpriced IPV Contract Items

Unpriced Items. Raytheon erroneously charged unpriced items to the IPV contract at prices greater than the DLA standard unit price. The overcharges occurred on contract modifications that had items purchased before the effective date of the modification. In fact, a number of items remain unpriced. An unpriced contract item is an item that is included on the contract but no price was negotiated and agreed upon at the time the item was purchased. The IPV contract at Cherry Point is basically silent on how unpriced items should be billed. DSCP contracting officials stated that the proper billing of unpriced items should be at the DLA SUP. Cherry Point was overcharged by \$328,990 (\$274,664 preexpended bins (PEB) and \$54,326 Navy Industrial Fund [NIF]) for the unpriced items.

For example, a machine screw (NSN 5305-01-089-1520) was priced on contract modification P00048, at \$0.0721 each or \$7.21 per hundred (effective October 5, 2000). The DLA SUP for the machine screws was \$8.33 per hundred. However, on invoices from May 1999 through March 2000, Raytheon charged Cherry Point \$1.39 each (\$139 per hundred), or 16 times the DLA SUP for 23,260 machine screws. The total amount billed on the contract for the machine screw was \$36,245, including Raytheon profit (6 percent) and DSCP surcharge (5.7 percent). The appropriate amount was \$2,171 a difference of \$34,074 or about 94 percent less.

Table 6 provides a summary of the amounts overcharged for unpriced PEB contract items at Cherry Point. The total amount overcharged was \$274,664. There were no overcharged PEB contract items on the April through July 2000 invoices.

Table 6. Raytheon Amount Overcharged for PEB Contract Items				
	<u>Modifications (effective date)</u>			
<u>Month</u>	<u>P00031 (April 2000)</u>	<u>P00048 (October 2000)</u>	<u>Unpriced Items</u>	<u>Total</u>
1999				
March	\$ 1,635	\$ 1,258	\$ 38,694	\$41,587
April	579	1,258	17,477	19,314
May	5,002	1,570	11,165	17,738
June	20,114	2,434	23,274	45,823
July	7,116	7,852	3,474	18,442
August	3,889	1,258	32,391	37,539
September	5,468	0	19	5,487
October	3,133	0	0	3,133
November	80	0	(20)	60
December	0	0	0	0
2000				
January	9,392	15,811	0	25,203
February	9,238	5,135	0	14,373
March	16,315	131	0	16,446
Material Cost	\$81,961	\$36,708	\$126,474	\$245,143
Raytheon Fee (6.0 percent)				14,709
Subtotal				\$259,852
DSCP Service Fee (5.7 percent)				14,812
Total				\$274,664

Table 7 provides a summary of the amounts overcharged for the NIF contract items at Cherry Point. The total amount overcharged was \$54,326. There were no overcharged NIF contract items on the May through July 2000 invoices.

Table 7. Raytheon Amount Overcharged for NIF Contract Items						
	<u>Modifications (effective date)</u>					
<u>Invoice</u>	<u>P00031</u>	<u>P00048</u>	<u>P00050</u>	<u>P00053</u>	<u>Unpriced</u>	<u>Total</u>
	<u>(April 2000)</u>	<u>(Oct-00)</u>	<u>(Oct-00)</u>	<u>(Nov-00)</u>	<u>Items</u>	
1999						
May	\$ 928	\$1,320	\$ 0	\$ 1	\$ 285	\$ 2,534
June	10,523	0	(53)	459	4,192	15,121
July	4,977	0	0	132	(76)	5,033
August	2,211	1,320	0	0	81	3,612
September	7,404	0	0	0	0	7,404
October	508	0	0	164	0	672
November	6,306	0	0	0	0	6,306
December	0	0	(94)	0	0	(94)
2000						
January	7,060	0	0	0	0	7,060
February	128	0	0	0	0	128
March	194	0	0	0	487	681
April*	30	0	0	0	0	30
Total	\$40,269	\$2,640	(\$147)	\$756	\$4,969	\$48,487
					Profit (6%)	2,909
						\$51,396
					Surcharge (5.7%)	2,930
						\$54,326

**Items that were billed before the contract modification date (4-17-00).*

DSCP needs to obtain a full refund from Raytheon for erroneous charges including lost interest and take appropriate steps to reimburse Cherry Point for the full amount of the contract overcharges.

Accounting for Different Units of Issue

Problems accounting for different units of issues were the primary cause for the erroneous charges. In the DLA wholesale inventory system, some items were packaged in multiple units of issue, such as hundreds (HD). The common practice at DSCP was to solicit items using the HD unit of issue, then convert any quotes received as each (EA) to HD. Conversion is often necessary because some suppliers only supplied the item in the EA unit of issue, and indicated this on their quotes. Similarly, for the IPV contract at Cherry Point, Raytheon's suppliers quoted using their customary EA unit of issue, and in the evaluation process these items were reviewed as having been quoted to the DLA unit of issue (HD or package), when in fact the prices were submitted as each.

Table 8 shows an example of erroneous pricing involving unit of issue differences and the associated cost impact. From May 1999 through January 2000, 2,300 machine screws (NSN 5305-00-839-3437) were billed at \$3.136 each. However, the contract price is \$4.43 per HD (although not actually negotiated until April 2000). The DLA SUP for the machine screws was \$3.31 per HD or \$0.0331 each. Since the machine screws had not yet been priced on contract and the item was not approved as a spot buy (items managed by DLA but not in stock), only the DLA SUP price should have been charged to the IPV contract.

Table 8. Erroneously Pricing of Machine Screws (NSN 5305-00-839-3437)				
<u>Description</u>	<u>Qty billed</u>	<u>Unit of Issue</u>	<u>Unit Cost</u>	<u>Total Cost</u>
Raytheon billing	2,300	EA	\$3.1360	\$7,214.95
Corrected billing	2,300	EA	0.0331	76.13
Amount overbilled				\$7,138.82

Corrective Actions. DSCP and Raytheon have taken action to address the unit of issue problems as first reported in Report No. D-2001-072. DSCP commented that Raytheon had implemented an NSN data management process and that the process begins when the customer identifies the NSN, through the solicitation review, and submission to DSCP. This process effectively screens all items so unit of issue problems will not recur. Raytheon works with the customer and DSCP to identify required baseline items. By screening site customer databases, comparing DLA unit of issue, and performing reconciliation, the right quantity and unit of issue are agreed to before submission to DSCP for formal placement on the contract. Within this process, any item unit of issue that can be broken into its lowest denominator is converted before being cited in Raytheon's request for quote to its suppliers (for example, 1 HD becomes 100 EA). This process translates the 'Government' unit of issue categorization into a 'commercial' categorization that is compatible with industry convention. These items are then highlighted in the pricing submission to DSCP and show the commercial bid as well as the Government price. In this way, DSCP can readily identify, and sort any necessary items that need translation in the bid evaluation process.

Contract Oversight

Invoice Oversight. DSCP also did not provide adequate oversight to ensure contract invoices were accurate. DSCP attempted to verify contract billings by matching contract prices to a contract database developed by a third party consultant. When discrepancies were discovered a file was made and forwarded to DSCP contracting officials for further review. DSCP contracting officials worked to resolve the discrepancies. However, the DSCP invoice verification process failed to detect unpriced items billed in excess of the DLA SUP to Cherry Point. In addition, Cherry Point relied on DSCP to ensure contract invoices were accurate and was unaware of being overcharged for unpriced items. Ordinarily under the IPV contract, if demand arose for an item that is not priced on the contract, Raytheon would check the DLA supply system for availability. If DLA did not have the item on-hand, Raytheon would request quotes from vendors and ask Cherry Point to authorize a spot buy at the vendors' price. Raytheon did not follow contract procedures by invoicing Cherry Point a price in excess of SUP for an unpriced item without proper authorization from Cherry Point.

DLA Supplied Items. In addition, Cherry Point was overcharged \$337,893 on invoices from December 1999 through March 2000 because Raytheon implemented a new bar-coding system that recorded prices for items from the DLA Supply system in error. The majority of errors were unit of issue and decimal point errors. Neither DSCP nor Raytheon detected this error. After Cherry Point notified DSCP of the problem, DSCP and Raytheon reviewed and corrected the invoices. Raytheon modified its procedure for invoicing DLA supplied items to ensure this error will not recur. Cherry Point received a check from Raytheon for \$337,893 on June 1, 2000.

In order to regain customer confidence that prices are accurately billed, DSCP needs to implement procedures to detect and prevent erroneous billings from occurring on future invoices.

Recommendations and Management Comments

B. We recommend that the Commander, Defense Supply Center Philadelphia:

1. Obtain a full refund from Raytheon for erroneous charges including lost interest and take appropriate steps to reimburse Cherry Point for the full amount of the contract overcharges.

2. Implement procedures to detect and prevent erroneous billings from occurring on future invoices.

Management Comments. The Defense Logistics Agency concurred with all recommendations and agreed to refund Cherry Point an appropriate amount for overcharges. Management also agreed to implement procedures to prevent erroneous billings on future invoices.

Appendix A. Audit Process

Scope

Work Performed. We reviewed DLA procedures and support contract documentation issued by DSCP to Raytheon under IPV contract SPO500-98-D-BP03. Specifically, we reviewed contract invoices from contract inception (August 19, 1998) through July 2000. We reviewed a total of 33,423 line items for benchstock items valued at \$11,124,708. Additionally, we determined if the IPV program reduced system infrastructure and depot operation costs. We reviewed DLA cost recovery rates for FY 1999 through FY 2001. We also reviewed spot buy procedures. Our review focused on whether the IPV program, when fully operational, is beneficial to Cherry Point and DoD as a whole.

Limitations to Scope. The adequacy of the DLA management control program was addressed in Inspector General, DoD, Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," therefore, we did not review it further.

DoD-Wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goals, subordinate performance goals, and performance measures:

- **FY 2001 DoD Corporate Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2)**
- **FY 2001 Subordinate Performance Goal 2.3:** Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms. **(01-DoD-2.3)**
- **FY 2001 Performance Measure 2.3.1:** Percentage of DoD Budget Spent on Infrastructure. **(01-DoD-2.3.1)**
- **FY 2001 Subordinate Performance Goal 2.4:** Meet combat forces' needs smarter and faster, with products and services that work better and cost less, by improving the efficiency of DoD's acquisition process. **(01-DoD-2.4)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Functional Area. Objective:** Foster Partnerships. **Goal:** Decrease paper transactions by 50% through electronic commerce and electronic data interchange. (ACQ-2.3)
- **Logistics Functional Area. Objective:** Develop a seamless logistics system. **Goal:** Improve the communication of logistics information (developing and implementing an integrated data environment to expand EDI, and enhance information exchange within DoD, with industry, other government agencies, and with allies. (LOG-2.2)

Methodology

Use of Computer-Processed Data. We relied on computer-processed data from the Defense Supply Center Philadelphia and Raytheon to determine the audit scope. The computer-processed data were determined reliable based upon the significant number of contract items we reviewed and compared to the data output from DSCP. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the bin locations, quantities, order dates, and amounts generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the audit objectives or that would change the conclusions in the report.

Audit Type, Dates, and Standards. We performed this program audit from December 2000 through February 2001 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did our work in accordance with generally accepted Government auditing standards except that we were unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review.

Contacts During the Audit. We visited or contacted individuals within the DoD and Raytheon. Further details are available on request.

Appendix B. Prior Coverage

During the last 5 years, the General Accounting Office has issued four audit reports and the Inspector General, DoD has issued eight audit reports discussing either logistics response time or prices for spare parts in the Acquisition Reform environment.

General Accounting Office

General Accounting Office, Report No. GAO-01-22 (OSD Case No. 2080), "Defense Acquisitions: Price Trends for the Defense Logistics Agency's Weapon Systems Parts," November 2000.

General Accounting Office, Report No. NSIAD-00-30 (OSD Case No. 1920), "Opportunities Exist to Expand the Use of Defense Logistics Agency Best Practices," January 2000.

General Accounting Office, Report No. NSIAD-00-21 (OSD Case No. 1868), "Management of Repair Parts Common to More than one Military Service can be Improved," October 1999.

General Accounting Office, Report No. NSIAD-99-90 (OSD Case No. 1808), "DoD Pricing of Commercial Items Needs Continued Emphasis," June 1999.

Inspector General, DoD

Inspector General, DoD, Report No. D-2001-072, "Industrial Prime Vendor Program at the Naval Aviation Depot - North Island," March 5, 2001.

Inspector General, DoD, Report No. D-2000-099, "Procurement of the Propeller Blade Heaters for the C-130 and P-3 Aircraft," March 8, 2000.

Inspector General, DoD, Report No. D-2000-098, "Spare Parts and Logistics Support Procured on a Virtual Prime Vendor Contract," March 8, 2000.

Inspector General, DoD, Report No. 99-217, "Sole-Source Commercial Spare Parts Procured on a Requirements Type Contract," July 21, 1999.

Inspector General, DoD, Report No. 99-101, "Logistics Response Time for the Direct Vendor Delivery Process, Defense Supply Center, Columbus," March 4, 1999.

Inspector General, DoD, Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998.

Inspector General, DoD, Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998.

Inspector General, DoD, Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Logistics)
Director, Acquisition Initiatives
Director, Defense Procurement
Under Secretary of Defense (Comptroller/Chief Financial Officer)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy
Commanding Officer, Fleet Industrial Supply Center, San Diego
Commanding Officer, Naval Aviation Depot, Cherry Point
Commanding Officer, Naval Aviation Depot, North Island

Department of the Air Force

Assistant Secretary of the Air Force (Acquisition)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency
Director, Defense Logistics Agency

Other Defense Organizations (cont'd)

Commander, Defense Supply Center Columbus
Commander, Defense Supply Center Philadelphia
Commander, Defense Supply Center Richmond

Non-Defense Federal Organizations

Office of Management and Budget
Office of Federal Procurement Policy

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FORT BELVOIR, VIRGINIA 22060-6221

IN REPLY J-3
REFER TO


JUL 20 2001

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,
DEPARTMENT OF DEFENSE

SUBJECT: Audit Report No. D1999CF-0104.001 on Industrial Prime Vendor Program at Naval
Aviation Depot, Cherry Point, North Carolina

Attached are our comments to the subject report. Questions may be referred to Paul Sabatini,
703-767-3760 or Ms. Sharon Nelson, 703-767-6274.

Attachment


HAWTHORNE L. PROCTOR
Major General, USA
Director,
Logistics Operations

We have reviewed the Audit Report on the Industrial Prime Vendor Program (IPV) at Naval Aviation Depot – Cherry Point (Project No. D199CF-0104.001) and submit the following comments:

GENERAL COMMENTS:

A. 1.a. Require that IPV contract prices be renegotiated on contract modifications that are not within established cost goals (about 20 percent above mean acquisition unit cost or below standard unit price).

Comment: Concur with clarification.

Even though pricing evaluations use a running aggregate of individual item prices, periodic reviews of actual item usage against contract prescribed quantities are performed and items are re-priced using revised demand. This “cost driver” process allows prioritization in pricing efforts for priced (i.e. re-pricing based on increased demand) and the remaining un-priced items.

A. 1. b. Aggressively look at alternatives to keep conventional benchstock support competitive by either reducing costs or increasing sales.

Comment: Concur

We are developing the follow-on initiative, Integrated Prime Vendor Generation II, which will use a concept of operation that is designed to provide logistic support alternatives based on best-value criteria in response to customer requirements. Accordingly, these best-value sourcing and distribution decisions will impact the balance of business via commercial or conventional benchstock support.

A. 1. c. Calculate a fair and consistent cost recovery rate for traditional benchstock material to effectively evaluate the cost effectiveness of the IPV program. The fair and consistent cost recovery rate for traditional benchstock material should exclude unrelated or IPV program expenses and should also address the impact of transferring sales from traditional support without reducing infrastructure costs.

Comment: Concur with explanation.

DSCP has no control over the application of expenses to our operations, which must be recovered through our business operations. Most of the decisions to add such costs to DLA or the Services are decided by OSD. These decisions are made to build costs into the rate structures to finance DoD expenses. In FY 01, DoD recognized that the Defense Reutilization and Marketing Office had lost \$265M over 3 years. It was the decision of the OSD Comptroller that DLA would recover that 3-year loss in 1 year. It was the decision of the DLA Comptroller to spread this cost equally to the three DLA Hardware Centers. The impact was dramatic for DSCP G&I. However, these decisions can also

artificially lower rates. For example, in FY 99 DoD Comptroller used cash to buy down the rates, which means the FY 99 DLA rates were artificially low. The benchstock items were reduced \$53M. Without the buy-down, the computed rates for benchstock commodities ranged from 58 – 67 percent.

There were some IPV related costs built into the FY 01 benchstock rate. Approximately \$2.7M was added to the overall benchstock commodity costs. This raised the traditional surcharge 1.1 points. This shift was part of the start-up financing of IPV. As with any new initiative, development costs are incurred before sales are recorded. IPV will be self-financed in FY 02.

The recent high surcharges were not caused by a lack of infrastructure reductions. The rates in FY 00 are lower than the DoD subsidized FY 99 rates. FY 01 rates increased due to the DRMS allocation. Without the DRMS cost in the FY 01 rates, benchstock items would have been commensurate with FY 00.

Regardless, agree with using an appropriate cost recovery rate for pricing analysis of IPV benchstock items. Routinely, we will use the established CRR. On exception, we may consider using a CRR adjusted for anomalies. For example, we are using an adjusted CRR of FY 01 in line with the FY 00 rate.

A.1.d. Develop an exit strategy for Cherry Point, in case the IPV contractor continues to be unable to obtain benchstock material as cost effectively as the Defense Supply Centers.

Comment: Concur

NADEP Cherry Point has been very satisfied with the performance of the IPV program. Item availability has greatly increased while overall benchstock costs have been in line with the traditional DLA system. Accordingly, upon completion of the 2-year base period, NADEP CP chose to exercise contract option continuing IPV support for 3 additional years. IPV Generation II provides NADEP CP exit strategy alternative.

B. 1.a. Obtain a full refund from Raytheon for erroneous charges including lost interest and take appropriate steps to reimburse Cherry Point for the full amount of the contract overcharges.

Comment: Concur.

During initial implementation, NADEP CP personnel ordered parts from the Raytheon system that had only been priced for the NADEP NI effort. Therefore, the prices charged were correct. A review of where a lower price was subsequently accepted for NADEP CP is being finalized. Upon completion an appropriate refund will be executed.

B. 1.b. Implement procedures to detect and prevent erroneous billings from occurring on future invoices.

Comment: Concur.

Department of the Navy Comments



DEPARTMENT OF THE NAVY

NAVAL AVIATION DEPOT
PSC BOX 8021
CHERRY POINT, NC 28533-0021

IN REPLY REFER TO:

4400
Code 6.1.520-WMC
18 JUL 2001

From: Commanding Officer
To: Inspector General, Department of Defense, 400 Army Navy Drive, Arlington,
Virginia 22202-4704

Subj: PROJECT NUMBER D1999CF-0104.001 REPORT

1. In response to Subject report stated that Naval Aviation Depot Cherry Point, has until July 9, 2001 to review and provide comments. Below are observations and comments regarding the report.

a. Executive Summary - I think that the auditors hit the nail on the head in identifying the small percentage of items actually "priced" and on contract. Raytheon procures less than 20% of the items through sub-vendors. Getting more items priced on the contract has been my number one goal and the subject of almost every review conducted with Defense Supply Center Philadelphia (DSCP) and Raytheon. The objective states that the primary goal was to determine whether the "program had demonstrated an effective shift to commercial, industrial-base resources as an integrated logistics solution". Based solely on that statement, I would have to agree that they haven't. However, another issue, which is as important, if not more, so, is the "Fill Rate". How many times does an artisan go to the bins to get material and how many times is the material available? That is a vital part in meeting our organizational schedules and goals. While I agree they need more items "priced" on the contract, our bottom line goal is material availability and this program has reached that goal in an overwhelming manner.

b. Page 5, Figure 2 - The first issue here is using the cost comparison. Under Raytheon, the projected \$450,000 for transportation was never charged or implemented. This would have increased the savings by another \$450K. Secondly, the statement that the \$750,000 on Defense Logistics Agency (DLA) side of infrastructure reduction could not be substantiated is true. While the actual number of 15 personnel could not be substantiated, it is a fact that we were understaffed. Our estimate at this depot was approximately 20 personnel. However, due to budget shortfalls, we were unable to hire additional people. It was estimated by DSCP that the number would have been 15 personnel. I think this is a good ball park figure. I really don't know how we would go back and absolutely identify the number. In reality, this number was not a cost saving since we didn't have those people on board. It could have been listed as a cost avoidance.

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c. Page 5-6, Market Baskets – I think that one of the main issues between Raytheon and DSCP is and always has been is pricing. The methodology to determine equal and fair pricing has been the hold up since contract award. Raytheon pushed the aggregate pricing method. Any contract specialists can nickel and dime you to death by looking at each and every item on contract and judging it on its own merit. By using the aggregate method, Raytheon would have been able to get better prices on more items, thereby getting more items on contract. While the aggregate method is debatable, it is an acceptable commercial practice.

d. Summary – While I agree with Department of Defense, Inspection General assessment, cost alone should not be the primary factor in determining continuation of the program. The success of any program should be measured by the satisfaction of the users. When we entered the program, it was not this depot's idea of saving a tremendous amount of money. Last year we spent \$284M on material for all programs. We only spent \$9.7M with Raytheon on this project. That is less than 3.5% of our total material expenditures. This year we are on track to spend \$318M for material with about \$12M with Raytheon (3.8%) our main objective has always been material availability. We were getting about 80% delivery from DSCP prior to IPV implementation. We now have a fill rate in excess of 97%.


e. Cost Recovery Rates (CRR) – This is an issue, which arises when you discuss any Prime Vendor initiative, it doesn't have to be. If DLA would reduce their infrastructure as they increase the use of Industrial Prime Vendor/Virtual Prime Vendor (IPV/VPV) and other new innovative methods of material support, there would not be a problem. If DLA sells 10% of all their material requirements through Direct Vendor Delivery (DVD), IPV, VPV, and other similar methods, they should be able to reduce their infrastructure by a proportionate amount. Regardless of what type of contract you implement, there will be overlap. We will be supporting both programs at the same time. However, infrastructure reduction by DLA is a must to keep the CRR down to a manageable level.

f. Overcharges/Refunds – I think it should be noted that this depot first identified the overcharges for December 1999 through March 2000. It should also be noted that once identified, Raytheon corrected the program error in their billing program, identified the over-charges, and issued a check to cover the amount overcharged. In every instance, Raytheon has been very cooperative in resolving issues which arise.

g. Raytheon and DSCP Surcharges – In an effort to reduce our costs, DSCP and Raytheon have re-negotiated their rates with us. DSCP has stopped charging their surcharge on the infrastructure, a charge that we have questioned for a long time. Also, due to a re-organization, Raytheon has reduced their infrastructure from \$126K to \$104K per month. Most of this was due to the movement of purchasing from their East Coast to their Havelock Office. I am now sharing the cost of some of the local buyers with the other East Coast sites.

h. Recommendations -- I agree with the cause of most of the problems and recommendations, however, I do feel that this is basically a good program. While I would like to save more money, material availability is our primary concern. On page 14, paragraph A.d, development of an exit strategy for Cherry Point is the furthest thing from our mind. Our working relationship with DSCP and Raytheon has been very good and I would hate to see support to our artisans diminish in any way.

2. For additional information regarding this response, point of contact is Mr. Bobby Meadows, (252) 464-7776 or DSN 451-7776.


J. C. ADAMS
By Direction

Audit Team Members

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